

Section III Asset Management

Chapter 4

Financial Operations

4.1

Introduction

This chapter addresses loan servicing related to the financial operations of projects insured under Section 232. For the purposes of this chapter, the term “Servicer” means the primary Servicer responsible for servicing the mortgage loan, whether such party is the originating Lender or third party Servicer for the originating Lender.

4.2

Financial Submission Requirements

The *Healthcare Regulatory Agreement - Borrower* (Forms HUD 92466, HUD 92466-EH and HUD 92466-ORCF) requires the submission of audited annual financial information for the Borrower. Additionally, amendments in 2012 to the Uniform Financial Reporting Requirements rule (24 CFR 5.801 et seq.), applicable to all Section 232 Operators (amendments addressed in this chapter and also delineated in the *Healthcare Regulatory Agreement – Operator*, Form HUD 92466A-ORCF) require submission of quarterly/year-to-date and annual financial statements from the Operator. This same 24 CFR 5.801 requires that financial submissions for all Section 232 related projects (both Borrower and Operator) be submitted concurrently to HUD and the Lender.

Borrowers are required to submit their annual financial statements within ninety days of their fiscal year end into the Financial Assessment Subsystem (FASS) which uploads the financial statements into the Integrated Real Estate Management System (iREMS), which ORCF uses in its routine asset management of projects. Guidelines for accounting from HUD’s Real Estate Assessment Center (REAC), revised submission procedures formulated in 2004, and the guidelines for REAC submissions, can be found on the REAC website.

HUD systems perform an analysis of the financial submission of the Borrower to measure the financial condition of the project and to assess compliance with applicable laws, regulations and business documents. HUD requires Borrowers to submit audited financial statements each year to the mortgagee and to HUD. HUD analyzes these financial statements to assess compliance with program requirements, to evaluate the financial strength of the Borrower, and for many other purposes. Servicers should conduct their examination to the extent necessary to classify asset values and make risk assessments.

- A. FASS performs an initial assessment of the financial condition of the Borrower's statement, as well as a review of the project's compliance with applicable laws, regulations and business documents. Compliance deficiencies identified either by this assessment or the project's auditor may be referred to ORCF or the Departmental Enforcement Center (DEC).

B. Borrower Submission Requirements:

In addition to Regulatory Agreement financial submission requirements, the Uniform Financial Reporting Requirements rule (24 CFR 5.801 et seq.) requires the electronic submission to HUD and the Servicer of Borrower financial information prepared in accordance with Generally Accepted Accounting Principles (GAAP).

1. For Profit Borrowers are required to electronically submit an audited Annual Financial Statement (AFS) within 90 days after the end of each fiscal year,
2. Non-profit Borrowers (receiving \$500,000 or more annually in combined federal assistance) are required to electronically submit a Borrower-certified (unaudited) AFS within 90 days after the end of the fiscal year. An electronically submitted, audited AFS is due no later than nine months after the end of the fiscal year pursuant to OMB Circular A-133. The Borrower may opt to submit the audited AFS within 90 days after the end of the fiscal year. By submitting the audited AFS within 90 days the Borrower may eliminate the additional step of submitting a Borrower-certified AFS.
3. Non-profit Borrowers (receiving less than \$500,000 annually in combined federal assistance) are required to electronically submit a Borrower-certified AFS within 90 days after the end of the fiscal year.

- C. The HUD systems review of the Borrower's financial statement in FASS may generate a Project Action "AFS Evaluation Financial Risk." This system generated action appears in the iREMS Dashboard of the Account Executive's (AE) projects. The AE will review the Project Action and contact the project or Servicer for additional details or actions necessary to comply with the FASS.

D. Operator Submission Requirements:

1. As set forth in 24 CFR Part 5.801, unless otherwise specified by HUD, Operator shall submit, on a quarterly and year-to-date basis (or more frequently if specified by HUD), prepared and certified by an authorized representative or agent of Operator, such financial reports relating to the operation of the Healthcare Facility (including, but not limited to, financial statements, accounts receivable/payable aging reports and occupancy reports) in the formats and at such times as may be approved by HUD in accordance with Program Obligations.
2. Detailed requirements for Operator quarterly and year-to-date submissions will be conveyed via the Section 232 Program website.

3. Such reports must be submitted no later than thirty (30) days after the period covered by the reports, except for reports relating to the final quarter of each year, which shall be submitted no later than sixty (60) days after end of the fiscal year. Such reports are subject to the sanctions contained in 18 U.S.C. Sections 1001, 1010, and 1012.

E. Ongoing Master Tenant Financial Requirements:

Master Tenant shall submit, or cause to be submitted, to HUD and Lender, on a quarterly and year-to-date basis (or more frequently if specified by HUD), prepared and certified by an authorized representative or agent of Master Tenant, such financial reports relating to the Master Tenant. Such reports must be submitted no later than thirty (30) days after the period covered by the reports, except for reports relating to the final quarter of each year, which shall be submitted no later than sixty (60) days after end of the fiscal year. Such reports are subject to the sanctions contained in 18 U.S.C. Sections 1001, 1010, and 1012. Additional information regarding the Master Tenant financial submission will be provided for on the Section 232 Program website.

F. Midsize and Large Portfolio Post Closing Quarterly Financial and Operational Review and Analysis:

For the entity that was the subject of a corporate credit review, HUD will require ongoing submission of the same financial and operational information. The data to be collected on a quarterly basis will include:

1. Narrative summary of significant events impacting financial and operational results
2. Census data
 - a. Count of available beds/units identified by level of care and payor type
 - b. Census days identified by level of care and payor type
3. Revenue
 - a. Resident care revenue by level of care and payor type
 - b. Other revenue
4. Operating Expenses – level of detail:
 - a. Salary expenses
 - b. Other operating expenses
 - c. Bad debt
 - d. Management fees
 - e. Reserve for capital expenditures

Exclude:

- i. Depreciation
- ii. Rent/Lease payment
- iii. Interest expense
- iv. Income taxes

- 5. Balance Sheet
 - a. Assets – level of detail:
 - i. Current Assets
 - ii. PP&E
 - iii. Accumulated depreciation
 - iv. Other assets
 - b. Liabilities – level of detail:
 - i. Current liabilities
 - ii. Long term debt
 - iii. Other liabilities
 - c. Member Equity/(Deficit)

4.3

Financial Analysis Support Team (FAST)

A. Failure to Submit:

If the Borrower fails to submit the AFS within the required timeline;

1. REAC's Financial Accounting Subsystem (FASS) triggers a non-filer/late filer referral to DEC through the iREMS. The DEC then notifies the AE, via the online system.
2. When a non-filer Borrower referral is made to the AE, the ORCF FAST financial analyst works directly with the Borrower or his agent to determine why the submission was not made, and, if necessary, provides filing assistance. This assistance may require iREMS data field correction, Active Partners Performance System (APPS), Secure Connection/Secure Systems (WASS) Access or User Maintenance problem resolution.
3. If necessary, a referral is made to DEC for additional assistance or for legal action.
4. The AE is copied on all correspondence with the Borrower, Borrower's agent or DEC and the AE determines whether a change to the iREMS risk rating is necessary.

B. AFS Compliance Review:

1. REAC identified compliance deficiencies may be referred to ORCF or DEC, in accordance with the OHP/REAC/DEC Memorandum of Understanding. In the case of ORCF referrals, a compliance letter requesting a response to the findings is emailed to the Borrower's FASS Coordinator, requesting a response to be sent to their AE and a Project Action is created within iREMS.
2. If the Borrower is overdue in responding, the AE contacts the Borrower to follow up on the status.

3. All responses received by the AE are sent to FAST. The AE will seek further clarification of the problem and provide information to a FAST financial analyst, who then performs further analysis of the compliance finding and its explanation. If necessary, the FAST financial analyst may request evidence of correction of the finding or further clarification.
4. iREMS is updated and any noncompliance flags in APPS are resolved by the FAST financial analyst, if applicable.
5. If the financial analyst is unable to resolve the compliance deficiency, they will notify the AE, and an elective referral may be made to the DEC for resolution.
6. The FAST financial analyst may recommend that the AE require monthly internally prepared financial statements for further monitoring; at which time the AE may change the Risk Indicator in iREMS to “Potentially Troubled” or “Troubled” status, depending on the situation.

4.4

Financial Assessment System (FASS) Submissions

- A. The project must notify their Servicer within two business days of receiving a Notification of Failure to File Financials by the required deadline in Financial Assessment System (FASS).

This notification is sent automatically to the email the project registered in the system when a deadline for submission of annual financial information is missed.

- B. Once notified, the Servicer must work with the project to ensure submission is forthcoming, and address any delays.

The Servicer must notify the AE if there are extenuating circumstances that are preventing the immediate submission, and provide the AE with the action plan to submit the required information expeditiously.

- C. Extended periods without filing FASS requirements by the deadline will warrant referral to the DEC, and additional actions may be taken by HUD to ensure compliance.

4.5

Financial Risk Metrics of Operator

- A. Key Indicators

The annual and quarterly review of the project operations by the Operator, coupled with the annual Borrower financial submissions, will allow both HUD and the Servicer to maintain an ongoing understanding of performance. Key indicators of the Operator financial statements

will be used to monitor performance and to measure against future routine reviews. Typically the annual and quarterly reviews are all that are necessary for monitoring the financial operations of a project; however, HUD does reserve the right to require monthly financial reports (of the Operator, the Borrower, or both) to be submitted (to HUD, the Servicer or both) if financial indicators suggest this level of monitoring is needed or if noncompliance with HUD business agreements (by the Borrower, Operator or Management Agent) is suspected.

Many activities and requirements occur throughout the life of a Section 232 project that will need to be analyzed and monitored. In this regard, below is a list of the key financial metrics that will be reviewed quarterly, using Operator financial data. If the Borrower is the same legal entity as the Operator, then the Borrower itself will submit the Operator financial data. The key metrics are:

1. Debt Service Coverage
2. Days Cash on Hand
3. Average Payment Period
4. Working Capital
5. Change in Receivables

B. Debt Service Coverage

1. The ability for a project to cover all debt obligations is one of the strongest indicators of financial health. This indicator is required to meet specific thresholds during the Section 232 application review process, and that threshold is to be held to similar expectations during the life of the Section 232 project. Although other components will also shape the overall financial strength of a project, the Debt Service Coverage Ratio (DSCR) should have the heaviest weight of the financial analysis. The formula to be used when calculating the DSCR is below. It requires the Servicer's use of both Operator and Borrower financial information. Please note that Net Operating Income (NOI) listed below does not include the following in the expenses (that are subtracted from income for the calculation of NOI): rent/lease expense, depreciation expense, amortization expense, or Mortgage Insurance Premium (MIP).

$$\text{DSCR} = \frac{\text{NOI}}{\text{(mortgage principal + mortgage interest payment + MIP)}}$$

2. When quarterly analysis shows a DSCR below 1.2, the Servicer shall notify the AE and monitor the project closely for the next quarter, reviewing a full six months of financials at this point. When analysis shows a DSCR below 1.2 for a second subsequent quarter, the Servicer must notify the AE, and the project will be placed in a "Potentially Troubled" status in the iREMS system.
 - a. Once in the Potentially Troubled stage, the Servicer must request an improvement plan from the Operator.

- b. The Borrower may not be aware of the declining DSCR, and the Servicer is responsible for ensuring that they are made of the aware of the Potentially Troubled status.
- 3. If any quarterly financial submission results in a DSCR below a 1.0, the Servicer must immediately notify the AE and work together with HUD and the Operator to determine actions necessary to resolve the financial decline.
 - a. A drop below a 1.0 DSCR, regardless of the time frame, shall warrant a decline to “Troubled” status in the iREMS system, by the AE.
 - b. The Servicer must notify the Borrower of the decline to Troubled status.

C. Days Cash on Hand

- 1. The numbers of days cash on hand for a project is an important evaluation of their financial ability to pay ongoing expenditures. Though some projects may not keep a significant amount of days cash on hand, due to the way their financial structure is set up with a parent of the Borrower or Operator, as a general rule, this metric is an evaluation tool for reviewing a project’s stability. The formula to be used when calculating the Days Cash on Hand is below:

Days Cash on Hand =

$$\frac{(\text{operating cash} + \text{investments (not including restricted escrows such as R4R, Bond Sinking Funds, etc.)})}{(\text{total expenses} - \text{depreciation} - \text{amortization})} \times \text{days in period}$$

- 2. A project with less than 14 days cash on hand may have sufficient funds for paying a two-week payroll, but may not have additional funds to cover other expenses. When this metric falls below 14, the Servicer must contact the AE, who should then move the project’s status to “Potentially Troubled” in the HUD system. The Operator must provide the Servicer with an action plan (seeking the Servicer’s guidance, as necessary) to increase the available cash and the Servicer will then continue to monitor the quarterly financial information until they exceed the 14 day cash threshold.
- 3. Using the above formula, a project with less than 7 days cash on hand is in danger of not being able to cover operating expenses. When this occurs, the Servicer must work with the Operator to evaluate an existing action plan, if applicable, or devise a new action plan to increase the cash on hand, and must immediately contact the AE to notify them of the situation. The AE will work with the Servicer and the Operator to take other financial metrics into consideration (DSCR, occupancy, etc.) and work toward increasing financial stability for the project.

The AE will also move the project to “Troubled” status in the HUD system.

- 4. As mentioned above (in section D1), there are scenarios where a project may not maintain a significant amount of cash on hand, and the Servicer will be responsible

for understanding those situations and determining if they provide an exception to following actions. The Servicer is responsible for notifying the AE of such situations and closely monitoring a project that falls below the Days Cash on Hand criteria for a Potentially Troubled or Troubled project.

D. Average Payment Period

1. The Servicer will review the Average Payment Period (APP) from the quarterly financial submissions. Changes in the APP will be an important metric to monitor in conjunction with the DSCR, and aged payables may be an indication of difficulty in State reimbursements or that an Operator is not using their funds appropriately.

Average Payment Period =

$$\frac{\text{(current liabilities)}}{\text{(total expenses – depreciation expense – amortization expense)}} \times \text{days in period}$$

2. The APP may not be a solitary trigger of a troubled account; if, however, APP is over 70 days (2+ months), this may be indicator of a larger problem.
3. If the timing of State reimbursements for a project is behind in receivables, then the project's APP would likely also be delayed by a comparable number of days. If the quarterly financial data shows the APP is over 70 days, the Servicer shall monitor the project's financials closely for the coming quarter(s). The Servicer will need to take the other financial metrics discussed in this section into account in addition to the aged payables and changes that have occurred in past quarters, to determine financial stability of individual projects.
4. The Servicer must notify the AE when the APP exceed 70 days, and determine together if the project should be moved to a "Potentially Troubled" status in the HUD system, and further monitored or if an action plan is warranted.
5. When the APP exceeds 90 days (3 months), the Servicer must immediately notify the AE, and the project will be moved to "Troubled" status in the HUD system. At this time an action plan, if not already in place, must be created by the Operator, and provided to the Servicer and AE, to ensure the project is able to pay its accounts and adequately cover other operating expenses.

E. Working Capital

1. Adequate working capital is needed to cover short-term obligations coming due in the current fiscal year. Positive working capital (Current Assets exceed Current Liabilities) is essential for the operating viability of the project. Negative working

capital (Current Liabilities exceed Current Assets) could represent liquidity problems for the project. Some projects may not keep adequate levels of working capital on their balance sheets due to their financial structure with the Parent or Borrower. For projects to which 24 CFR Sec. 232.1013 applies, failure to maintain positive working capital will preclude Operator distributions. As a general rule, this metric is used as an evaluation tool to review the project's ability to maintain a positive working capital position. To evaluate working capital, the Current Ratio provides a basic measure to determine the amount of current assets that can be converted to cash to cover short-term liabilities coming due.

$$\text{Working Capital} = \frac{\text{current assets} - \text{current liabilities}}{\text{current liabilities}}$$

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

NOTE: Due to fluctuations in dollar amounts based on project size, the above 'Current Ratio' formula is to be used for analyzing Working Capital.

2. Projects with a current ratio of 1.20 times should have adequate liquidity to pay short-term liabilities. Should the Current Ratio fall between 1.20 and 1.10 times, the Servicer must contact the Operator to discuss the adequacy of the ratio and, if necessary, a possible action plan to increase working capital. Depending on the need for an action plan, the Servicer shall contact the AE, who will move the project's status to "Potentially Troubled".
3. Projects with a current ratio of less than 1.0 may need to liquidate some long-term assets or issue short-term debt to pay its short-term liabilities. The Servicer must immediately work with the Operator to implement an action plan to increase working capital and contact the AE to notify them of the situation. The AE will work with the Servicer and Operator to ensure that other financial metrics provide financial stability for the project. The AE will move the project status to "Troubled" in the HUD system.
4. As mentioned above (item E1) in certain conditions, a project may not maintain significant amounts of working capital and the Servicer will be responsible for understanding those conditions and determining if an exception to the above actions is warranted. The Servicer is responsible for notifying the AE of such conditions and closely monitoring a project that falls below the Current Ratio criteria for a Potentially Troubled or Troubled projects.

F. Change in Receivables

1. As with the average payment period, Accounts Receivable (AR) may also be an indicator of a project's ability to adequately cover operating expenses and maintain financial and operational stability. Monitoring changes in AR should provide an understanding of the project's ability to maintain financial stability at varying levels of payables and/or receivables.

Days in AR =

$$\frac{\text{Patient accounts receivable}}{(\text{total revenues})} \times \text{days in period}$$

2. When patient accounts receivables exceed 70 days (2+ months), the Operator must provide the Servicer with an action plan (seeking the Servicer's guidance, as necessary and appropriate) for ensuring that there are enough funds for the project to operate sufficiently. This will include taking the other key financial metrics into account. The Servicer must also notify the AE, and together determine if the project should be moved to a "Potentially Troubled" status in the HUD system.

Depending on how a project has set up their balance sheets, the aged AR may appear to be a trigger of a potentially troubled status, when it is not a true trigger, so it will be necessary for the Servicer to very closely evaluate the metrics when reviewing this calculation.

3. When a quarterly financial review indicates AR exceed 90 days (3 months), the Servicer must immediately notify the AE, and the project will be moved to "Troubled" status in the HUD system. At this time an action plan, if not already in place, must be created by the Operator, Servicer and AE, to ensure the project is able to pay its accounts and adequately cover other operating expenses.

G. Withdrawal of Project Funds (Distributions)

As set forth in federal regulation 24 CFR 232.254, and applicable only to transactions for which a firm commitment has been issued on or after July 12, 2013, with mortgage insurance transactional documents consistent with the regulation (see in particular the ORCF *Healthcare Regulatory Agreement – Operator*, and specifically Sections 15 and 16 thereof), a Borrower may make and take distributions of mortgaged property, to the extent and as permitted by the law of the applicable jurisdiction, provided that:

1. The calculation shall be made no less frequently than semi-annually.
2. The Borrower must demonstrate positive surplus cash. To the extent surplus cash is negative, the Borrower must repay any distributions taken during such calculation period within 30 calendar days, unless a longer time period is approved by HUD.
3. The Borrower shall be deemed to have taken distributions to the extent that surplus cash is negative, unless in conjunction with the calculations of surplus cash, the

Borrower provides to HUD documentation evidencing, to HUD's reasonable satisfaction, a lesser amount of total distributions.

Note, however, that the distributions of an Operator in transactions for which a firm commitment was issued on or after July 12, 2013, are governed separately by 24 CFR 232.1013, and if a Borrower and Operator are the same legal entity then that entity's distributions are constrained by both the Borrower restrictions and the Operator restrictions.

H. Servicer's Analysis of Its Overall Portfolio

To have a full and accurate picture of the financial condition of its portfolio, Servicers must assess the probability that existing loans might not be repaid. Servicers will need to estimate the losses that could be incurred and to establish procedures for assessing the risk inherent in each loan in their portfolios. An annual meeting between a Servicer and their assigned AE(s) should be conducted to align risk mitigation efforts. The Servicer shall contact the AE when the project is experiencing operational challenges which may warrant discussions amongst the parties.